JUN 21

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 142

AMERICAN SURETY COMPANY OF NEW YORK, a corporation,

Petitioner,

vs.

PAUL W. SAMPSELL, as Trustee in Bankruptcy of the Estate of Charles B. Stratton, doing business under the fictitious firm names and styles of Temple City Building Materials Co. and Stratton Construction Co.,

Respondent.

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit, and Brief in Support Thereof.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No.....

AMERICAN SURETY COMPANY OF NEW YORK, a corporation,

Petitioner,

vs.

PAUL W. SAMPSELL, as Trustee in Bankruptcy of the Estate of Charles B. Stratton, doing business under the fictitious firm names and styles of Temple City Building Materials Co., and Stratton Construction Co.,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Your petitioner, American Surety Company of New York, prays that a writ of certiorari issue to review the final judgment of the United States Circuit Court of Appeals for the Ninth Circuit determining that the dividends on petitioner's allowed general claim in bankruptcy are to be paid to certain other general creditors of the bankrupt to whom petitioner is not and has never been indebted.

Opinions Below.

The opinion of the Circuit Court of Appeals [R. 126] is not yet reported. The opinion of the District Court [R. 93] is reported at 53 F. Supp. 131, *sub nom. In re Stratton.*

Jurisdiction.

The judgment of the Circuit Court of Appeals for the Ninth Circuit was entered on April 24, 1945 [R. 131]. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, Chapter 229, Section 1, 43 Stat. 938; 28 U. S. C. A. §347(a); and under Section 24(c) of the Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 553; as amended by the Act of June 22, 1938, c. 575, §1, 52 Stat. 854; 11 U. S. C. A. Supp. §47(c).

Questions Presented.

1. In a case involving the rights of parties under a bond executed pursuant to state statute where the provisions of the statute are a part of the bond, does not the refusal of a bankruptcy court to consider such state statute and relevant state court decisions constitute a determination of the controversy without appropriate regard for rights acquired under rules of state law?

2. In a bankruptcy proceeding where a dispute arises between claimants, should not a federal court give effect to state law governing their substantive rights?

3. May dividends declared on a surety's allowed claim in bankruptcy properly be paid to certain other creditors of the bankrupt to whom the surety is not and has never been indebted?

4. Is there any equitable basis—either under federal law or state law—for depriving a surety of the usual

bankruptcy rule of equality of distribution where the surety's claim is for subrogation after full payment of all creditors under a statutory bond in a case where certain potential creditors of the surety were not paid solely because of their own lack of diligence in failing to take the steps required by state statute to become actual creditors under the bond?

Statutes Involved.

1. Section 65(a) of the Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 563; as amended by the Act of June 22, 1938, c. 575, §1, 52 Stat. 875; 11 U. S. C. A. Supp. §105(a):

> "Dividends of an equal per centum shall be declared and paid on all allowed claims, except such as have priority or are secured."

2. Section 1183 of the Code of Civil Procedure of California (1872), as amended by Cal. Stats. (1929) pp. 1924, 1926-27:

> ". . . In case the surety or sureties on any bond given as in this chapter provided shall have caused said bond to be filed and recorded in the office of the county recorder of the county in which the property is situated, before the work of improvement is completed, then no action may be maintained thereon unless there shall previously have either been filed a mechanic's lien claim as in this chapter provided or unless written notice shall previously have been given to the surety on said bond before the expiration of the time prescribed in this chapter for filing a lien to enforce such claim. . . . ."

The provisions of said Section 1183 of the Code of Civil Procedure of California are set forth in their entirety in the appendix, *infra*.

Statement.

The facts in the case at bar are stipulated and undisputed. [R. 85-92.]

On January 2, 1941, Charles B. Stratton, the bankrupt here, contracted with General Electric Company to make certain alterations in that company's factory building at Ontario, San Bernardino County, California. [R. 87.]

On January 3, 1941, Stratton applied to petitioner, American Surety Company of New York, for a statutory laborers' and materialmen's bond [R. 58-67, 85-86]. In his application Stratton agreed to indemnify the surety [R. 63-66]. The same day, Stratton as principal, and petitioner as surety, executed a bond entitled "Laborers & Materialmen, Statutory Form for California" in the penal sum of $33,950 [R. 86-88]. This bond is set forth in full in the record [R. 86-88] and in the opinion of the Circuit Court of Appeals [R. 126-128].

On January 7, 1941, the plans and specifications, the construction contract and the bond were filed and recorded in the office of the Recorder of San Bernardino County pursuant to Section 1183 of the California Code of Civil Procedure [R. 88]. Under California law referred to hereafter, the provisions of that statute—Section 1183—became a part of the bond as if incorporated in *haec verba*.

Thereafter, Stratton, as original contractor, set about to effect the construction work required by the contract, and on September 10, 1941, a notice of completion was recorded. It is stipulated that on October 10, 1941, under state law (§1187 California Code of Civil Procedure), the time expired for laborers and materialmen to file and

record "mechanic's lien" claims or to give notice to the surety [R. 89].

Five laborers and materialmen filed and recorded claims of lien or lodged timely written notices with the surety setting forth the furnishing of labor and materials, as required by Section 1183 of the California Code of Civil Procedure [R. 89-90].

The surety thereupon paid in full each claim of these five laborers and materialmen who so recorded claims of lien or lodged notices as required by Section 1183 of the California Code of Civil Procedure, as follows:

Soule Steel Company	$4,767.09
Emil Brown & Company	1,498.42
Harold Shugat Company	265.78
Valley Window Cleaners	126.85
Shattuck Lumber Company	66.64
	$6,724.78

[R. 90-91.]

On November 27, 1941, Stratton was adjudged a bankrupt and Paul W. Sampsell, respondent here, was appointed trustee [R. 11]. Thereafter, American Surety Company filed with the referee in bankruptcy its proof of claim for $6,987.48 based upon the indemnity agreement of Stratton and upon subrogation, for the surety had paid the aforesaid five claims aggregating $6,724.78 and had incurred expenses of $262.70—a total of $6,987.48 [R. 29, 54-57]. The surety's claim for $6,987.48 was allowed as a general claim [R. 30].

Among the other general claims filed there appeared the proofs of claims of Jack Campbell for $805.10, Probert Manufacturing Company for $385 and Tony

Stevens for $146.01—a total of $1,336.11, based upon labor and materials claimed to have been furnished to Stratton in connection with the General Electric Company contract [R. 36, 91-92]. *None* of these three claimants ever recorded any claim of lien or gave any notice whatsoever to the surety, as required by Section 1183 of the California Code of Civil Procedure [R. 91].

It is stipulated that, in addition to the three last mentioned claimants, there are two other persons who furnished labor and materials on Stratton's contract and who remain unpaid in the total sum of $259.13. These two persons likewise failed to record any mechanic's lien or give any notice to the surety as required by the statute. In addition, no proof of claim in bankruptcy was ever filed on behalf of these two [R. 91-92]; nor is any reference to these two parties found in the decision of the court below.

In the course of the bankruptcy proceedings the claims of Jack Campbell, Probert Manufacturing Company and Tony Stevens—the three parties above mentioned who neglected to record any claim of lien or to give any notice to the surety—were regularly allowed as general claims in bankruptcy [R. 35-37].

It is also stipulated that there are numerous other general unsecured claims against the estate of the bankrupt other than those directly involved in the case at bar [R. 36, 92].

The trustee in bankruptcy, respondent Sampsell, petitioned for [R. 48-52] and obtained from the referee on June 15, 1943, the following order:

> ". . . said Trustee . . . is directed not to pay any dividend on the general claim of American

Surety Company of New York in the sum of $6,987.48 unless and until the claims of Jack Campbell, in the sum of $805.10, Probert Manufacturing Company in the sum of $385.00 and Tony Stevens in the sum of $146.01 have been paid in full, and such amount of the dividend otherwise payable on the claim of the American Surety Co. of New York as may be required when divided pro rata amongst the named three creditors, shall be applied on their claims, in addition to their ordinary dividend until their claims have been paid in full or the dividends otherwise payable to the American Surety Company of New York, have been exhausted: after the said three creditors have been paid in full, then the balance remaining of the dividends otherwise payable to the American Surety Company of New York, if any, shall be paid to said surety company" [R. 38].

It is conceded that under this order petitioner will receive nothing on its allowed claim.

From a judgment of the District Court affirming the referee's order, petitioner appealed [R. 98-100]. The Circuit Court of Appeals affirmed the judgment of the District Court [R. 131], and petitioner now seeks review by certiorari.

Reasons for Granting the Writ.

1. This cause involves questions of far-reaching importance in the administration of justice on the "equity side" by courts of bankruptcy throughout the nation, necessitating an authoritative determination by this Court.

2. The decision of the Circuit Court of Appeals, refusing to consider or give any effect to rights acquired

under a state statute[1] and state decisions[2] in a controversy between certain claimants in bankruptcy, is in conflict with the applicable decisions of this Court.

That decision [R. 130] conflicts with the decisions of this Court holding that a court of bankruptcy may not make its determination in such case "without appropriate regard for rights acquired under rules of state law."

Prudence Realization Corp. v. Geist, 316 U. S. 89, 95, 62 S. Ct. 978, 86 L. ed. 1293, 1298 (1942);

Prudence Realization Corp. v. Ferris, 323 U. S. 650, 89 L. ed. (Adv. Ops.) 456, 458 (1945).

3. The decision of the Circuit Court of Appeals conflicts with the fundamental bankruptcy rule that contractual rights established by state law will be recognized and considered, where the sweep of the Bankruptcy Act does not require a contrary determination. This was true even before *Erie R. Co. v. Tompkins*, 304 U. S. 64, 58 S. Ct. 817, 82 L. ed. 1188 (1938).

Corn Exchange National Bank & Trust Co. v. Klauder, 318 U. S. 434, 437, 63 S. Ct. 679, 87 L. ed. 884, 886, note 8 (1943);

Holt v. Crucible Steel Co., 224 U. S. 262, 265, 32 S. Ct. 414, 56 L. ed. 756, 757 (1912).

And, as here, where the federal court is governed by the rules of equity, due regard must be accorded the state law concerning the substantive rights between the parties.

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[1]§1183 of The Code of Civil Procedure of California (1872), as amended by Cal. Stats. (1929) pp. 1924, 1926-27.

[2]Carpenter v. National Surety Co., 25 Cal. App. (2d) 90, 93, 76 P. (2d) 523 (1938); A. L. Young Machinery Co. v. Cupps, 213 Cal. 210, 219, 2 P. (2d) 321 (1931); Republic Iron & Steel Co. v. Patillo, 19 Cal. App. 316, 318-319, 125 P. 923 (1912); Smith v. McKnight, 117 Cal. App. 427, 428, 4 P. (2d) 305 (1931); Kleinclaus v. Dutard, 147 Cal. 245, 249, 81 P. 516 (1905).

See:

Ruhlin v. New York Life Ins. Co., 304 U. S. 202, 58 S. Ct. 860, 82 L. ed. 1290 (1938).

4. The decision of the Circuit Court of Appeals, ordering the dividends on petitioner's allowed claim in bankruptcy to be paid to certain other creditors of the bankrupt to whom petitioner never has been indebted, is in conflict with the applicable decisions of this Court.

Having paid in full all persons who became creditors on the statutory bond, petitioner is entitled under the settled rule of this Court to subrogation against the insolvent debtor; and the judgment of the court below is therefore in conflict with the following decisions.

American Surety Co. v. Westinghouse Electric Mfg. Co., 296 U. S. 133, 137, 56 S. Ct. 9, 80 L. ed. 105, 109 (1935);

Jenkins v. National Surety Co., 277 U. S. 258, 266, 48 S. Ct. 445, 72 L. ed. 874, 876 (1928);

United States v. National Surety Co., 254 U. S. 73, 76, 41 S. Ct. 29, 65 L. ed. 143, 144-145 (1920).

5. The decision of the Circuit Court of Appeals, depriving petitioner of the usual bankruptcy rule of equality of distribution by ordering the dividends on petitioner's allowed claim to be paid to three non-diligent parties, is in conflict with the applicable decisions of this Court.

The claims of petitioner and of said three claimants stand on the same plane as to the assets of the bankrupt. The purpose of Section 65(a) of the Bankruptcy Act, to bring about a ratable distribution among all general claimants, has been violated in the proceeding at bar.

Young v. Higbee Co., ... U. S. ..., 89 L. ed. (Adv. Ops.) 578 (No. 342, Oct. Term, 1944—Feb. 26, 1945).

6. The decision of the Circuit Court of Appeals is contrary to the basic equitable principle observed in all federal courts that equity aids the diligent and not those who sleep upon their rights. No equities in favor of the three claimants ever arose from the suretyship, for they failed to take the statutory steps required to become obligees on the bond.

7. The decision of the Circuit Court of Appeals for the Ninth Circuit, awarding the dividends payable to petitioner to three parties who made no attempt to qualify as creditors under the statutory bond, is directly in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in *Moise v. Scheibel,* 245 Fed. 546 (1917), where the terms of the bankruptcy order there reversed were almost identical with that at bar.

Conclusion.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari should be granted to review the judgment of the Circuit Court of Appeals for the Ninth Circuit.

June, 1945.

AMERICAN SURETY COMPANY OF NEW YORK, a corporation,

Petitioner,

By WILLIAM C. MATHES,

Counsel for Petitioner.

MATHES & SHEPPARD and
GORDON F. HAMPTON,

Of Counsel.

IN THE

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Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

May it Please the Court:

Opinions Below.

The opinion of the Circuit Court of Appeals [R. 126] is not yet reported. The opinion of the District Court [R. 93] is reported at 53 F. Supp. 131, *sub nom. In re Stratton.*

Jurisdiction.

The grounds upon which the jurisdiction of this Court is invoked are stated in the petition at page 2.

Statement of the Case.

The facts appear in the petition at pages 4 to 7, and in the interest of brevity are not repeated herein.

However, a brief reference to the nature of the controversy and the parties involved is pertinent in presenting the major federal issues raised in the case at bar.

Petitioner is the holder of an allowed general claim in bankruptcy based upon subrogation[3] to the rights of five of the bankrupt's creditors fully paid by petitioner as the surety upon the bond furnished pursuant to California statute[4] [R. 29-30, 54-57].

Reduced to its terms, this is a controversy between claimants—that is, between petitioner and three other general bankruptcy claimants represented by respondent trustee. The disposition of the dividends payable on petitioner's claim is at issue. The three claimants are asserting right to such dividends and therefore urging a departure from the fundamental policy of the Bankruptcy Act expressed in Section 65(a) as follows:

> "Dividends of an equal per centum shall be declared and paid on all allowed claims, except such as have priority or are secured." (11 U. S. C. A. Supp. §105(a).)

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[3] In the interests of brevity the reference throughout is to subrogation; however, petitioner also asserts the related right of indemnity based upon contractual agreement with the bankrupt [R. 63-67].

[4] §1183 of the California Code of Civil Procedure.

Specification of Errors.

The Circuit Court of Appeals erred:

1. In determining this controversy "without appropriate regard for rights acquired under rules of state law"[5] through its refusal to recognize the California statute[6] and decisions[7] establishing the fact that on its surety bond petitioner has never been liable to certain other claimants to the bankrupt estate in whose favor petitioner's claim is subordinated by its decision [R. 130].

2. In failing to give any effect to state law governing the substantive rights of claimants where a dispute arises between them in a bankruptcy proceeding [R. 130].

3. In ordering the dividends on petitioner's allowed claim in bankruptcy to be paid to certain other creditors of the bankrupt to whom petitioner is not and has never been indebted [R. 128-129].

4. In depriving the surety, contrary to equitable principles, of the usual bankruptcy rule of equality of dis-

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[5]Prudence Realization Corp. v. Geist, 316 U. S. 89, 95, 62 S. Ct. 978, 86 L. ed. 1293, 1298-99 (1942);

Prudence Realization Corp. v. Ferris, 323 U. S. 650, 89 L. ed. (Adv. Ops.) 456, 458 (1945);

Ruhlin v. New York Life Ins. Co., 304 U. S. 202, 58 S. Ct. 860 82 L. ed. 1290 (1938).

[6]§1183 of the Code of Civil Procedure of California (1872), as amended by Cal. Stats. (1929), pp. 1924, 1926-27.

[7]Carpenter v. National Surety Co., 25 Cal. App. (2d) 90, 93, 76 P. (2d) 523 (1938); A. L. Young Machinery Co. v. Cupps, 213 Cal. 210, 219, 2 P. (2d) 321 (1931); Republic Iron & steel Co. v. Patillo, 19 Cal. App. 316, 318-319, 125 P. 923 (1912); Smith v. McKnight, 117 Cal. App. 427, 428, 4 P. (2d) 305 (1931); Kleinclaus v. Dutard, 147 Cal. 245, 249, 81 P. 516 (1905).

tribution (§65(a), Bankruptcy Act) where the surety's claim is for subrogation after full payment of all creditors under the statutory bond in this case where certain potential creditors of the surety were not paid solely because of their own lack of diligence in failing to take the steps required by state statute to become actual creditors under the bond [R. 129-130].

Summary of Argument

1. Federal regard for substantive rights established by state law is required in the case at bar.

2. The Ninth Circuit specifically refused to consider rights acquired under state law.

3. Petitioner is not and has never been liable to the three claimants represented by respondent.

4. Petitioner has been deprived of its dividends contrary to established equitable principles, both federal and state.

(a) Equity will not aid the three non-diligent claimants.

(b) It is inequitable to deprive the subrogated surety of its dividends.

5. The decision of the Ninth Circuit in denying the equality of distribution required by the Bankruptcy Act conflicts with the decision of the Eighth Circuit in *Moise v. Scheibel.*

ARGUMENT.

1. Federal Regard for Substantive Rights Established by State Law Is Required in the Case at Bar.

It is part of federal law itself that appropriate recognition in bankruptcy is to be accorded substantive rights acquired under state law.

> *Prudence Realization Corp v. Geist*, 316 U. S. 89, 95, 62 S. Ct. 978, 86 L. ed. 1293, 1298-99 (1942);
>
> *Prudence Realization Corp. v. Ferris*, 323 U. S. 650, 89 L. ed. (Adv. Ops.) 456, 458 (1945).

The court below erroneously assumed that it was proper to exclude from consideration the interplay of state and federal law in this cause. This is a dangerous misconception, for, as this Court stated in *Prudence Realization Corp. v. Geist*, 316 U. S. 89, 95, 62 S. Ct. 978, 86 L. ed. 1293, 1298-99 (1942):

> "The court of bankruptcy is a court of equity to which the judicial administration of the bankrupt's estate is committed, . . . and it is for that court —*not without appropriate regard for rights acquired under rules of state law*—to define and apply federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims which, in other respects, are of the same class." (Italics added.)

Thus the federal bankruptcy law looks to state law as a fact or circumstance of high importance in determining the status of petitioner's claim. The instrument upon

which all parties here base their asserted rights was a bond intertwined with a state statute and state decisions. Thus in order to do equity in the case at bar the bankruptcy court must necessarily give effect to the state law.

See:

Ruhlin v. New York Life Ins. Co., 304 U. S. 202, 58 S. Ct. 860, 82 L. ed. 1290 (1938).

Just as the courts have looked to rules of state law in determining the time when a preference is perfected under the Bankruptcy Act, so, here, it is essential to look to the state law which fixed the relationship of the parties prior to bankruptcy.

See:

Corn Exchange National Bank & Trust Co. v. Klauder, 318 U. S. 434, 437, 63 S. Ct. 679, 87 L. ed. 884, 886, note 8 (1943).

It is submitted that the decision of the Circuit Court of Appeals is in conflict with the foregoing applicable decisions of this Court.

2. The Ninth Circuit Specifically Refused to Consider Rights Acquired Under State Law.

Despite the fact that the substantive rights involved here are grounded solely upon a statutory bond the provisions of which cannot be determined without due consideration for a state statute and state decisions, the Circuit Court of Appeals refused to give effect to such statute or such decisions [R. 130].

In the opinion below it is stated that here the "determination was governed by Federal law, not State law," and that "We therefore have no occasion to consider the State court decisions cited by appellant" [R. 130]. But these bare statements do not solve the questions at bar. On the contrary, under the applicable decisions of this Court—that is to say, under the federal law itself—a court of bankruptcy in this cause must not act without appropriate regard for state law, since the foundation of this controversy will be shown to rest upon a bond which embodies the provisions of a state statute.

3. Petitioner Is Not and Has Never Been Liable to the Three Claimants Represented by Respondent

In *Carpenter v. National Surety Co.*, 25 Cal. App. (2d) 90, 93, 76 P. (2d) 523 (1938), the court said:

> "The bond is a statutory bond authorized by Section 1183 of the Code of Civil Procedure. As such the terms of the statute are read into the bond and control its interpretation and effect."

Under the terms of Section 1183 of the California Code of Civil Procedure, set forth in the appendix, *infra*, petitioner did not assume any liability whatsoever to any materialman or laborer "unless there shall previously have either been filed a mechanic's lien claim . . . or unless written notice shall previously have been given to the surety before the expiration of the time prescribed . . . for filing a lien to enforce such claim . . ."

It is stipulated that five diligent materialmen and laborers filed mechanic's lien claims or gave notice to petitioner and were paid in full [R. 90-91]. It is also stipulated that five other materialmen and laborers neither filed mechanic's lien claims nor gave any notice whatsoever to petitioner as surety. As stated, three of the latter parties are represented here by respondent and two of them did not file claims in bankruptcy [R. 91-92].

Under the California decisions it is clear that the filing of a lien, or the giving of digect notice, was indispensable to charging petitioner with liability on its bond.

A. D. Young Machinery Co. v. Cupps, 213 Cal. 210, 219, 2 P. (2d) 321 (1931);

Republic Iron & Steel Co. v. Patillo, 19 Cal. App. 316, 318-319, 125 P. 923 (1912);

Smith v. McKnight, 117 Cal. App. 427, 428, 4 P. (2d) 305 (1931).

Thus as pointed out in the concurring opinion in *Eberhart v. United States*, 204 Fed. 884, 891 (C. C. A. 8th, 1913):

> "Because the conditions on which alone" the sureties "had agreed to be liable to any laborer or materialman . . . had never arisen" the sureties "were as free of liability to them as . . . if they had never signed the bond, and they remain so unto this day."

It is, therefore, beyond dispute that petitioner never at any time became indebted to the three claimants represented by respondent.

4. **Petitioner Has Been Deprived of Its Dividends Contrary to Established Equitable Principles, Both Federal and State.**

(a) EQUITY WILL NOT AID THE THREE NON-DILIGENT CLAIMANTS.

Regardless of whether federal law or state law is determinative of the case at bar, both jurisdictions observe the same governing principles of equity. Thus it is a fundamental and "familiar principle that equity favors the diligent, and not those who slumber on their rights."

Williams v. Banana Distributing Co., 59 F. (2d) 645 (C. C. A. 6th, 1932).

See, also:

Hammond v. Hopkins, 143 U. S. 224, 250, 12 S. Ct. 418, 36 L. ed. 134, 145 (1892);

Kleinclaus v. Dutard, 147 Cal. 245, 249, 81 P. 516 (1905).

Not only is there a state statute—Section 1183 of the California Code of Civil Procedure—governing the question of lack of diligence on the part of the three claimants represented here by respondent, but that statute is part and parcel of the surety bond furnished by petitioner. (*Carpenter v. National Surety Co., supra*, 25 Cal. App. (2d) 90, 93, 76 P. (2d) 523 (1938).)

The filing of claims in bankruptcy by the three claimants was sufficient to enable them to share ratably in the general assets of the estate but certainly does not entitle them to receive the dividends on petitioner's claim as a windfall in addition to their own dividends, as the order affirmed by the Circuit Court of Appeals would permit.

It is submitted that it was grossly inequitable for the bankruptcy court to subject petitioner's dividends to what amounts to an equitable execution in favor of the three claimants. These three claimants were nothing more than bare general claimants in bankruptcy. At one time they had been potential creditors on petitioner's statutory bond. But they made no attempt to qualify as actual creditors by filing the necessary notice or claim of lien as required by the statute. Therefore, prior to bankruptcy they had waived all protection of the bond.

The provisions of that statute—Section 1183 of the California Code of Civil Procedure—are substantive, not technical requirements. They have a purpose cognizable in equity. For as the court under parallel circumstances said in *Republic Iron & Steel Co. v. Patillo, supra,* 19 Cal. App. 316, 318-319, 125 P. 923 (1912):

> ". . . we then find a failure on the part of . . . the court to find, that plaintiff had filed any verified statement . . . setting forth the amount of its claim within thirty days from the time the improvement was completed . . . It cannot be said that a compliance with the statutory requirement in this regard would prove of no benefit to the sureties, and that, therefore, it may be disregarded . . . the filing of the verified claim . . . showing that the bounden principal has failed to pay for materials, furnishes a means of notice to such sureties and by timely action they may be able to protect themselves, where, without such notice their remedy might be lost."

See, also:

A. L. Young Machinery Co. v. Cupps, supra, 213 Cal. 210, 219, 2 P. (2d) 321 (1931).

The cases last cited are two of the state court decisions which the Circuit Court of Appeals had "no occasion to consider" [R. 130].

The provisions of Section 1183 of the California Code of Civil Procedure are, therefore, indispensably precedent to obligation. Being substantive in purpose, those provisions constitute an enactment into statute declaring the policy of the law which regulated the conduct of the parties.

Thus the three claimants never became anything more than *potential* creditors of petitioner. The language of *In re L. & R. Wister & Co.*, 237 Fed. 793, 795 (C. C. A. 3rd, 1916), is pertinent:

> ". . . it is going rather far to hold, that a court of bankruptcy, in its orderly administration of justice, will reach into its general equity powers and find a means to restore to a 'person a right which is conferred upon him by statute and *which he lost by his own neglect.*'." (Italics added.)

It seems clear, then, as stated in *Estate of Houston*, 205 Cal. 276, 283, 270 P. 939 (1928), that each of the five non-diligent parties, including the three at bar, "alone is at fault in having negligently allowed his rights to sleep, and hence equity will not come to his aid." And this is equally true whether the court of equity be federal or state. It is *solely* because of their own neglect that the three claimants were not paid.

(b) It Is Inequitable to Deprive the Subrogated Surety of Its Dividends.

The judgment of the Circuit Court of Appeals directly conflicts with a rule well settled by the decisions of this Court. Petitioner's case *meets* the test of this rule that "the surety may not claim subrogation against an insolvent debtor until the creditor is paid in full. . . ."

Jenkins v. National Surety Co., 277 U. S. 258, 266, 48 S. Ct. 445, 72 L. ed. 874, 876 (1928).

See:

United States v. National Surety Co., 254 U. S. 73, 76, 41 S. Ct. 29, 65 L. ed. 143, 144-145 (1920);

Since the terms of Section 1183 of the California Code of Civil Procedure are part of this statutory bond, petitioner became obligated *only* to those materialmen and laborers who made themselves known to petitioner by filing mechanic's liens or giving notice. (*Carpenter v. National Surety Co., supra*, 25 Cal. App. (2d) 90, 93, 76 P. (2d) 523 (1938); *Republic Iron & Steel Co. v. Patillo, supra*, 19 Cal. App. 316, 318-319, 125 P. 923 (1912).)

The case of *American Surety Co. v. Westinghouse Electric Mfg. Co.*, 296 U. S. 133, 56 S. Ct. 9, 80 L. ed. 105 (1935), which the court below purports to follow, fully supports petitioner's position. In the *Westinghouse* case there was no statute such as Section 1183 of the Code of Civil Procedure. Accordingly, in that case all materialmen and laborers became creditors of the surety. There was no question of diligence. The surety there became indebted to *each* claimant, but did *not* pay in full those to whom it was obligated. There the surety paid

the penal sum of the bond to creditors, but this was not sufficient to go around. Thus, each materialman and laborer in the *Westinghouse* case *was a creditor* of the surety but only *partially* paid. The essential difference between that case and this is that here the surety never became indebted to the three claimants who by the order of the court below are to receive the dividends on petitioner's claim.

The Court stated that the surety

> "may not share in the assets of the principal by reason of such payment until the debts thus partially protected have been satisfied in full. . . . 'A surety liable only for part of the debt does not become subrogated . . . unless he pays the whole debt or it is otherwise satisfied.'"
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> *American Surety Co. v. Westinghouse Electric Mfg. Co.*, 296 U. S. 133, 137, 56 S. Ct. 9, 80 L. ed. 105, 109 (1935).

But in the case at bar petitioner specifically complied with the rule. Here, at all times the surety stood ready, able and willing to pay in full all claims of those who came forward against the bond. Here, the surety did in fact pay in full all those to whom it became obligated. The case at bar is not a case, as was the *Westinghouse* case, where the face of the bond was not sufficiently ample and where the surety sought to compete with those whose claims it had paid only in part. Here, petitioner undertook to pay in full and did pay in full. Thus, there is nothing in the case at bar to prevent the subrogation or indemnification of petitioner.

There is another significant difference between the *Westinghouse* case and this. In that case the surety was attempting to compete with other diligent claimants to

whom it had not only been indebted but with respect to a particular fund or retained percentage which had been set up especially for their benefit. Thus there were strong equities favoring the claim of the creditors to that fund. The Court said that the creditors involved had "a right or an interest" against this retained percentage "which, even if not a lien in the strict and proper sense, brought kindred consequences along with it." (296 U. S. at 136, 80 L. ed. at 109.)

The succinct statement of this Court in the *Westinghouse* case is, therefore, especially pertinent:

> "Slight differences in facts may cause the equities to vary, and thus vary the result. * * * Our decision must be kept within the bounds of the controversy before us." (296 U. S. 133, 139, 56 S. Ct. 9, 80 L. ed. 105, 110, 111.)

The effect of the decision of the Circuit Court of Appeals in the proceeding at bar is well summed up in the words of *In re Kansas City Journal-Post Co.*, 144 F. (2d), 791, 800-801 (C. C. A. 8th, 1944):

> "While a bankruptcy proceeding, of course, 'is not itself a suit in equity', . . . the court essentially, in dealing with creditors' claims, 'sits as a court of equity', . . . but 'not without appropriate regard for rights acquired under rules of state law', . . .
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> * * * * * * * *
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> "But since bankruptcy, as we have suggested, is a final liquidation, the power of subordination necessarily must be measuredly and not blankly exercised. It must have a sound regard for the distribution results that will be produced to the creditor whose claim is being subordinated, as well as to the other creditors. It should not operate to take away anything punitively to which one creditor is justly entitled in view

> of the liquidation finality, and bestow it upon others, who in the relative situation have no fair right to it. . . ."

It is submitted that, in the case at bar, contrary to the applicable decisions of this Court, the power of subordination has been inequitably and "blankly exercised".

5. The Decision of the Ninth Circuit in Denying the Equality of Distribution Required by the Bankruptcy Act Conflicts With the Decision of the Eighth Circuit in Moise v. Scheibel.

In *Moise v. Scheibel*, 245 Fed. 546, 547 (C. C. A. 8th, 1917), the District Court had, among other things, ordered:

> ". . . that Moise should receive dividends upon his claim equally with all other creditors of the same class, except that the claim of the Omaha Auto Top Company should be preferred to that of Moise, and that any dividends that Moise should be entitled to should be paid to the Auto Top Company until its claim should be paid in full; . . ."

It will be noted that the provisions of the District Court's order in *Moise v. Scheibel, supra*, are practically identical with the order in the case at bar [R. 38-39], set forth in the petition at pages 6, 7. But, the Eighth Circuit corrected the lower court's error in *Moise v. Scheibel*, saying (245 Fed. at 547):

> "We, however, think the court erred in granting a preference to the claim of the Auto Top Company over that of Moise. They were creditors of the same class, and the evidence does not warrant the establishment of what practically amounts to a lien on the dividends payable to Moise, in favor of the Auto Top

> Company. The evidence tends to show that Moise promised orally that the indebtedness of the Auto Top Company should be paid; but there is no evidence of facts which would create an estoppel on the part of Moise from receiving his dividends on an equality with the Auto Top Company."

In other words, just as in case at bar, no creditor-surety relationship ever came into being, the oral promise to answer for the debt of another being unenforceable there under state law. There, as here, the promisee was a potential creditor. There, as here, the potential obligation failed to become effective because of lack of diligence on the part of the potential obligee. In *Moise v. Scheibel* the promisee failed to procure written evidence of the promise from the surety. In the case at bar the three potential obligees failed to give notice of their claims to the surety.

The decision of the Ninth Circuit in this cause is therefore in direct conflict with that of the Eighth Circuit in *Moise v. Scheibel*, 245 Fed. 546 (1917).

Manifestly, petitioner stands in the shoes of the five diligent parties who became obligees on the bond and are fully paid. In the event of filing of claims by these five diligent parties, they would have been entitled to a *pro rata* share of the general assets. Petitioner is entitled to that share by subrogation, for the basic purpose expressed in the Bankruptcy Act is to bring about a ratable distribution among claimants.

> *Young v. Higbee Co.*, ... U. S. ....., 89 L. ed. (Adv. Ops.) 578 (No. 342, Oct. Term, 1944—Feb. 26, 1945); §65(a), Bankruptcy Act; 11 U. S. C. A. Supp. §105(a).

Conclusion.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari should be granted and that this Honorable Court should review the decision of the United States Circuit Court of Appeals for the Ninth Circuit and finally reverse it.

June, 1945.

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APPENDIX.

Section 1183 of the Code of Civil Procedure of California (1872), as amended by Cal. Am. Code Amdts. 1873-74, p. 409; Cal. Code Amdts. 1880, p. 63, Cal. Stats. 1885, p. 143; Cal. Stats. 1887, p. 152; Cal. Stats. 1899, p. 34; Cal. Stats. 1903, p. 84; Cal. Stats. 1911, p. 1313; Cal. Stats. 1929, p. 1924; reads as follows:

"Mechanics, materialmen, contractors, subcontractors, artisans, architects, machinists, builders, miners, teamsters and draymen, and all persons and laborers of every class performing labor upon or bestowing skill or other necessary services, or furnishing materials to be used or consumed in or furnishing appliances, teams and power contributing to the construction, alteration, addition to or repair, either in whole or in part, of any building, wharf, bridge, ditch, flume, aqueduct, well, tunnel, fence, machinery, railroad, wagon road or other structure, or other work of improvement, or performing labor upon or bestowing skill or other necessary services, or furnishing materials to be used or consumed in or furnishing appliances, teams and power contributing to the grading, filling in, or other improvement of any lot or tract of land or the making of any improvement in connection therewith, including within the meaning of the said word "improvement" any seeding, sodding or planting of such lot or tract of land for landscaping purposes or the demolition of buildings thereon or the removal of buildings therefrom, made or done on such real property, shall have a lien upon the property upon which they have bestowed labor or furnished materials, for the value of such labor done and materials furnished and for the value of the use of such appliances, teams or power, whether at the instance of the owner, or of any other person act-

ing by his authority or under him, as contractor or otherwise; and every contractor, subcontractor, architect, builder or other person having charge of the construction, alteration, addition to or repair either in whole or in part of any building or other improvement as aforesaid shall be held to be the agent of the owner for the purposes of this chapter.

"Any person who performs labor in any mining claim or claims, or in or upon any real property worked as a mine, either in the development thereof or in working thereon by the subtractive process or furnishes materials to be used or consumed therein, has a lien upon the same and the works owned and used by the owners for milling or reducing the ores from the same, for the value of the work or labor done or materials furnished by each respectively, whether done or furnished at the instance of the owner of such mining claim or claims or real property worked as a mine, or his agent, and every contractor, subcontractor, superintendent or other person having charge of any mining or work or labor performed in and about such mining claim or claims or real property worked as a mine, either as lessee or under a working bond or contract thereon shall be held to be the agent of the owner for the purposes of this chapter.

"The liens in this chapter provided for shall be direct liens, and shall not in the case of any claimants, other than the contractor be limited, as to amount, by any contract price agreed upon between the contractor and the owner except as hereinafter provided; but said several liens shall not in any case exceed in amount the reasonable value of the labor done or material furnished, or both, for which the lien is claimed, nor the price agreed upon for the same between the claimant and the person by

whom he was employed, nor in any case, where the claimant was employed by a contractor, or subcontractor shall the lien extend to any labor or materials not embraced within or covered by the original contract between the contractor and the owner, or any modification thereof made by or with the consent of such owner, and of which such contract, or modification thereof the claimant shall have had actual notice before the performance of such labor or the furnishing of such materials. The filing of such original contract, or modification thereof, in the office of the county recorder of the county where the property is situated, before the commencement of the work, shall be equivalent to the giving of such actual notice by the owner to all persons performing work or furnishing materials thereunder.

"In case said original contract shall, before the work is commenced, be so filed, together with a bond of the contractor with good and sufficient sureties in an amount not less than fifty (50) per cent of the contract price named in said contract, which bond shall in addition to any conditions for the performance of the contract, be also conditioned for the payment in full of the claims of all persons performing labor upon or furnishing materials to be used in, or furnishing appliances, teams or power contributing to, such work, and shall also by its terms be made to inure to the benefit of any and all persons who perform labor upon or furnish materials to be used in or furnish appliances, teams or power contributing to, the work described in said contract as to give such persons a right of action to recover upon said bond in any suit brought to foreclose the liens provided for in this chapter or in a separate suit brought on said bond, then the court must, where it would be equitable so to do, restrict the

recovery under such liens to an aggregate amount equal to the amount found to be due from the owner to the contractor, and render judgment against the contractor and his sureties on said bond for any deficiency or difference there may remain between said amount so found to be due to the contractor and the whole amount found to be due to claimants for such labor or materials or both.

"No change or alteration of the work or modification of any such contract between the owner and his contractor, nor rescission or attempted rescission thereof, or of said bond, nor conditions precedent nor conditions subsequent, contained therein, attempting to limit the right of recovery under said contract or under the bond given for the benefit of laborers and materialmen under the foregoing provision nor any fraud practiced by any person other than such laborer, materialman or other persons seeking to recover thereon nor any change in any agreement pertaining to the furnishing of labor or materials, nor the terms or time of payment thereof, shall release or exonerate any surety or sureties upon any bond given under this section. All bonds given pursuant to the provisions of this chapter will be construed most strongly against the surety and in favor of all persons for whose benefit such a bond is given, and under no circumstances shall a surety be in anywise released from liability to the said laborers or materialmen or persons furnishing appliances, teams or power, for whose benefit said bond has been written, by reason of any breach of contract between owner and contractor or on the part of any obligee named in said bond, but the sole condition of recovery on the part of such person furnishing labor or material or appliances, teams or power as aforesaid, shall

be that said labor or material has been used or consumed in or said appliances, teams or power have contributed to the work of improvement to which said bond refers, and that the said third person for whose benefit said bond has so been made to inure has not been actually paid some part or all of the sums due him for the same.

"No provisions in any of the bonds given pursuant to any of the provisions of this chapter attempting by contract to shorten the period prescribed for the commencement of an action thereon as laid down in section 337 of this code, shall be valid if such provision attempts to limit the time for commencement of action thereon to a shorter period than six months from the completion of said structure or work of improvement, as "completion" is defined in section 1187 of this code, nor shall any provision in any of said bonds attempting to limit the period for the commencement of actions thereon be valid in so far as actions brought by persons furnishing labor or materials, appliances or teams or power as aforesaid, are concerned, unless said bond be filed for record, with the contract to which it refers, before the work of improvement is commenced, with the county recorder of the county or city and county in which the property referred to therein, or some part thereof, is situated.

"In case the surety or sureties on any bond given as in this chapter provided shall have caused said bond to be filed and recorded in the office of the county recorder of the county in which the property is situated, before the work of improvement is completed, then no action may be maintained thereon unless there shall previously have either been filed a mechanic's lien claim as in this chapter provided or unless written notice shall previously have been given to the surety on said bond before the expiration

of the time prescribed in this chapter for filing a lien to enforce such claim, which notice shall state that the person giving such notice has performed labor or furnished materials, or both, or furnished appliances, teams or power, to the contractor or other person acting by the authority of the owner, or that they have agreed to do so, stating in general terms the kind of labor, materials, appliances, teams or power and the name of the person to or for whom the same was done or furnished, or both, and the amount in value, as near as may be, of that already done or furnished, or both, and of the whole agreed to be done or furnished, or both. The filing of an action to foreclose such lien shall not be a condition precedent to a recovery on said bond. If said bond has been so filed as herein last provided then any suit brought against such surety or sureties shall be filed within six months after completion of said structure or work of improvement, as "completion" is defined in section 1187 of this code.

"The written notice to be given to the surety or sureties hereinabove provided for may be given by delivery thereof personally to, or by depositing same in the mail, postage prepaid, and registered, addressed,

(1) If to an individual surety, at his residence or place of business, if known, or

(2) If to an individual surety and his residence is unknown, then in care of the county clerk of the county in which said bond has been so filed, or

(3) At the place designated as the residence of the surety in the certificate, if any, filed by such surety or sureties as provided by section 1163 of the Civil Code, or

(4) If to a corporate surety, at the office or care of the agent designated by the surety in the bond as the address to which such notice shall be sent, or

(5) At the office or care of any officer of the surety in the state of California, or

(6) At the office of or care of the statutory agent of the surety in the state of California, or

(7) By service in the manner prescribed for the service of summons as provided by section 411 of the Code of Civil Procedure.

"It is the intent and purpose of this section to limit the owner's liability, in all cases, to the measure of the contract price where he shall have filed or caused to be filed in good faith with his original contract a valid bond with good and sufficient sureties in the amount and upon the conditions as herein provided. It shall be lawful for the owner to protect himself against any failure of the contractor to perform his contract and make full payment for all work done and materials furnished thereunder by exacting such bond or other security as he may deem necessary." (Italics added.)